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No. 83

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

TEXAS INTERNATIONAL AIRLINES, INC.,

Petitioner,

v.

NATIONAL AIRLINES, INC.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTIONS PRESENTED

May the defeated contestant in a takeover battle be held liable under Section 16(b) of the Securities Exchange Act of 1934, which, in order to prevent "the unfair use" of inside information, requires ten per cent shareholders to pay over to the corporation any short swing profits they make in the corporation's stock, when

(a) the defeated contestant never had any access to inside information; and

(b) the sole effect of the judgment would be to give the winning contestant a windfall discount on the purchase price the winning contestant agreed to pay the defeated contestant for its shares.

THE PARTIES

The parties' names are stated in the caption.* Although respondent, National Airlines, Inc. ("National"), was absorbed by merger into Pan American World Airways, Inc. ("Pan Am") and ceased to exist in January, 1980, Pan Am has continued the case in National's name. *See* Fed. R. Civ. P. 25(c).

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* Pursuant to Rule 28.1 of this Court, Petitioner, Texas International Airlines, Inc., provides the following information: Jet Capital Corporation, Texas Air Corporation, and Continental Airlines Corporation are corporate parents of Petitioner; Texas International Airlines Finance N.V. and Texas International Airlines Capital N.V. are subsidiaries of Petitioner; and New York Airlines, Inc., Continental Air Lines, Inc., United Micronesia Development Association, and Air Micronesia, Inc. are affiliates of Petitioner. This list excludes wholly-owned subsidiaries of Petitioner which do not have any publicly held securities and those wholly-owned subsidiaries of Petitioner's affiliates which do not have any publicly held securities.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Texas International Airlines, Inc. ("Texas International") respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit entered in this case on September 15, 1983.

OPINIONS BELOW

The majority and dissenting opinions of the Court of Appeals are officially reported at 714 F.2d 533, 542 (5th Cir. 1983) and unofficially reported at [Current] Fed. Sec. L. Rep. (CCH) ¶ 99,488 (5th Cir. Sept. 15, 1983). The opinion of the district court on liability is unreported. Each of these opinions is reprinted in the Appendix.

JURISDICTION

The judgment of the Court of Appeals was entered on September 15, 1983. This Court has jurisdiction to review the judgment of the Court of Appeals by writ of certiorari pursuant to 28 U.S.C. § 1254(1) (1976).

STATUTORY PROVISIONS INVOLVED

Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (1982), provides, in pertinent part:

> "For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months."

The phrase "such beneficial owner, director or officer" in Section 16(b) is a reference to language in Section 16(a) of the Act, 15 U.S.C. § 78p(a) (1982), which imposes certain filing and reporting requirements on:

> "Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to Section 12 of this title, or who is a director or an officer of the issuer of such security . . . ."

STATEMENT OF THE CASE

In July, 1978, Texas International announced that it would attempt a takeover of National. National reacted with extreme hostility, filing lawsuits, encouraging government investigations and attacking Texas International in the press. In a further effort to thwart Texas International's bid, National signed a merger agreement with Pan Am, a "friendly" suitor, under which Pan Am would buy out National's shareholders for cash. While Texas International did manage to acquire in excess of 10 per cent of National's stock, Texas International lost the battle when Pan Am obtained 51 per cent of National's stock and consequent power to force shareholder approval of the merger agreement.

In the interval between Pan Am's acquisition of majority ownership and the formal merger of Pan Am and National, Pan Am got an agreement from Texas International to sell to Pan Am in advance several hundred thousand shares of National stock at the same $50 per share price that all shareholders were to receive on the merger and, for additional consideration, to give Pan Am an option to purchase Texas International's remaining National holdings at a later time. Although at the time of this agreement Texas International had held the great majority of its National shares for more than six months, it had owned 121,000 shares for 48 days short of six months.

On August 2, 1979, Texas International filed suit in the district court for the Southern District of Texas for a declaratory judgment that it had no liability under Section 16(b) on the sale to Pan Am. The district court had jurisdiction of the suit under 28 U.S.C. §§ 1331, 1332 and 1337 (1976 & Supp. V 1982), and Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa (1982).

On September 26, 1979, National filed its answer and a counterclaim seeking recovery under Section 16(b). By early

January, 1980, the merger of Pan Am and National had been effectuated; Pan Am became the surviving corporation, and National ceased to exist as a corporate entity. Thus, the actual respondent in this case is Pan Am, *see* Del. Code Ann. tit. 8, § 259 (1975), and it is Pan Am which would receive any recovery on the counterclaim. To reflect this actual state of affairs, we will hereafter refer to respondent as "Pan Am."

The district court granted summary judgment on Pan Am's counterclaim, holding that Texas International was liable for the difference between the purchase price of the 121,000 shares bought within six months and the sale price of $50 per share, less brokerage commissions and transfer tax. On May 10, 1982, judgment was entered awarding Pan Am $1,149,195 plus prejudgment interest.

On appeal, a panel of the Fifth Circuit affirmed by a vote of 2-1, dividing over the meaning of this Court's decision in *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973). Despite Texas International's arguments that there were absolutely no policy reasons for construing the statute to cover the Texas International-Pan Am transaction and that there were strong policy reasons against allowing Pan Am to obtain a windfall discount on its contract price by obtaining Texas International's profit for itself, the panel majority ruled for Pan Am. The majority held that Texas International's argument that the statute did not apply to it was foreclosed by language in this Court's opinion in *Kern County*, even though this Court had found Section 16(b) not applicable to the disposition of target company shares by the failed takeover bidder in *Kern County*. (App. A at 11a.) As to the argument that Pan Am was estopped from obtaining a windfall discount on its contract price, the panel majority noted that equitable estoppel had never been recognized in a Section 16(b) case. (App. A at 5a-6a.)

Judge Garza dissented. Disagreeing with the majority's interpretation of *Kern County*, he stated that the spirit of *Kern County* required that Section 16(b) be read as not applying to this case: "The reason for the existence of § 16(b) is in no way

promoted by its application to the present transaction." (App. A at 17a-18a.) "The statute itself states that it was enacted for the 'purpose of preventing the unfair use of information which may have been obtained' by a statutory insider," and Texas International, which was attempting a hostile takeover, "had no 'inside information.' " (App. A at 17a.) Texas International received from Pan Am the same $50 per share price received by all National shareholders; application of Section 16(b) to require Texas International to make a refund "serves only to permit Pan Am to avoid that portion of its contract with TI in which it agreed to pay $50 per share." (App. A at 18a.) There was no Section 16(b) policy which would justify conferring this windfall on Pan Am.

REASONS FOR GRANTING THE WRIT

The panel majority below held that when Texas International bowed to the inevitable and sold its National shares to Pan Am, Section 16(b) forces were set in motion that compel the courts to return a portion of the agreed consideration to Pan Am. This resolution is contrary to the teachings of the Court, to the intent of Congress, and to all considerations of policy:

(i) the money paid as consideration for the shares cannot fairly be taken away from Texas International, which was not an "insider" in any sense;

(ii) Pan Am cannot fairly be permitted to obtain a windfall discount on the consideration Pan Am agreed to pay Texas International for its shares; and

(iii) the result permits Section 16(b) to interfere with the climate of investor opportunity that Congress has sought to create by the Williams Act, 15 U.S.C. §§ 78*l*-n (1982).

There was no compulsion under Section 16(b) for the Court of Appeals majority to decide as it did, and there is no Section 16(b) policy that would either be served by this unjust result or

disserved by a fair resolution of this case. Rather, the court below misunderstood this Court's decision in *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973), failed to recognize the applicability to Section 16(b) cases of this Court's decision in *Bangor Punta Operations, Inc. v. Bangor & Aroostook Railroad*, 417 U.S. 703 (1974), and failed to recognize the impact of its decision on the climate of investor opportunity sought by the Williams Act.

I. SECTION 16(b) CANNOT PROPERLY BE APPLIED TO TEXAS INTERNATIONAL, WHICH FAILED IN ITS HOSTILE TAKEOVER BID AND NEVER ACHIEVED ACCESS TO INSIDE INFORMATION

The most significant potential liability under Section 16(b) today is in connection with transactions which were virtually unknown at the time Section 16(b) was drafted—hostile takeover attempts.[1] Large blocks of stock are often bought and sold within short periods. Yet the purchase and later disposition of shares by a stockholder who has failed in a hostile takeover attempt does not present the potential for misuse of inside information which is Section 16(b)'s express justification; the very reason for the disposition of the shares is the failure to become an insider.

Having no appropriate role to play in the takeover context, Section 16(b) has become a kind of "wild card": it hurts the climate of maximum shareholder opportunity that Congress has sought to create with the Williams Act, discouraging some transactions, and irrationally recasting the terms of the bargain

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1 Tender offers began to become popular during the 1960's. E. Aronow, H. Einhorn & G. Berlstein, *Developments in Tender Offers for Corporate Control* at p. v (1978). The legislative history of the Williams Act, 15 U.S.C. §§ 78*l*-n (1982), enacted in 1968 to deal with this form of securities trading, recites that the number of tender offers in a year had increased from 8 in 1960 to 100 in 1966. S. Rep. No. 550, 90th Cong., 1st Sess., at 2 (1967).

in others. This Court has noted that the scheme of federal takeover and tender offer regulation does not include Section 16(b) and that Section 16(b) was "not designed for this task." *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 597-98 (1973).

One result of tender offers has been the creation of a new class of ten per cent stockholders who, precisely *because* of their stock ownership, are the most outside of outsiders. It is the fate of this class under Section 16(b) that is the subject of this petition. As this Court observed in *Kern County*, it is "totally unrealistic to assume or infer" that a shareholder who had acquired stock in a hostile takeover attempt had access to inside information. 411 U.S. at 596.

While this Court found in favor of the defeated takeover contestant in *Kern County*, the statutory analysis for reaching that result applied only to a narrow category of "unorthodox" transactions rather than to the general problem of purchases and subsequent sales by unsuccessful hostile takeover candidates. Indeed, the lower courts in this and other cases[2] have misread *Kern County* as prohibiting a purpose-oriented construction of the statute to deal with this general problem and have imposed liability on defeated takeover candidates without any policy justification. These incorrect results have impact far beyond the cases themselves. The threat of liability posed by the results of these cases has the effect of preventing many other transactions from taking place at all.

These results are contrary to this Court's purpose-oriented approach to construing Section 16(b) in *Kern County* and other cases, contrary to purpose-oriented principles of statutory construction announced many times by this Court, and

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2 *See Reece Corp. v. Walco National Corp.*, 565 F. Supp. 158 (S.D.N.Y. 1981); *Lane Bryant, Inc. v. Hatleigh Corp.*, 517 F. Supp. 1196 (S.D.N.Y. 1981); *Tyco Laboratories, Inc. v. Cutler-Hammer, Inc.*, 490 F. Supp. 1 (S.D.N.Y. 1980).

contrary to the purpose-oriented constructions employed by lower courts in cases involving the other two categories of Section 16(b) insiders: officers and directors.

On each of the three occasions on which this Court has addressed the reach of Section 16(b), this Court expressly has sought a construction of the statute which would reflect the statutory purpose. *See Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418, 424-25 (1972) (seller not liable for profits on second step of two step sale transaction where first step brought holdings below 10 per cent); *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 594 (1973) (defeated tender offer contestant not liable where shares sold to successful rival in "unorthodox" transaction); *Foremost-McKesson, Inc. v. Provident Securities Co.*, 423 U.S. 232, 244 (1976) (despite statutory language which might have been read to include the transaction, statutory coverage of purchase by which defendant became 10 per cent stockholder "not consistent with the premises on which Congress enacted the section").

As this Court recognized in *Foremost-McKesson*, the critical question in a Section 16(b) case is whether the statute applies in the first instance, since the statute "imposes liability without fault within its narrowly drawn limits." 423 U.S. at 251 (footnote omitted). In dealing with those who in fact had access to inside information, Congress deliberately chose not to require proof that they misused it, for that would involve chasing the "will-o'-the-wisp of an investor's 'intent.'" *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418, 425 (1972). Insiders always have some inside information, and it would be next to impossible to determine whether they used inside information in trading decisions.

The critical issue here thus is one of statutory coverage: whether a defeated takeover contestant who never had access to inside information at all should be regarded as a ten per cent shareholder within the meaning of Section 16(b) and thereby be conclusively presumed to have misused inside information

that it never had in the first place. There is no reason to read Section 16(b) to apply to the defeated takeover contestant.

This Court has said that to carry out the purpose of the Securities Exchange Act of 1934, it may be necessary to construe the statute as not applying to a situation which appears to fall within the letter of the statute. *See United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1975), where this Court quoted with approval the "traditional canon of statutory construction" set forth in *Church of the Holy Trinity v. United States*, 143 U.S. 457, 459 (1892):

> "a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers."

Indeed, in the course of construing statutes, "even when the plain meaning did not produce absurd results but merely an unreasonable one 'plainly at variance with the policy of the legislation as a whole,' " this Court frequently "has followed that purpose, rather than the literal words." *Perry v. Commerce Loan Co.*, 383 U.S. 392, 400 (1966) (quoting *United States v. American Trucking Associations*, 310 U.S. 534, 543 (1940)). As Justice Cardozo put it, the words chosen by Congress "came into the statute . . . freighted with the meaning imparted to them by the mischief to be remedied." *Duparquet Huot & Moneuse Co. v. Evans*, 297 U.S. 216, 220-21 (1936).

The express statutory purpose has guided the lower courts in construing Section 16(b) with regard to coverage of officers and directors, the two categories of insiders other than ten per cent shareholders. When confronted with a defendant who appeared to fall within the literal language of the statute because he was a "director," or an "officer," but who was not in fact an insider, courts have been unwilling to find coverage. (Director not liable: *see Gold v. Sloan*, 486 F.2d 340 (4th Cir. 1973), *cert. denied*, 419 U.S. 873 (1974). Officer not liable: *see, e.g., Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Livingston*, 566 F.2d 1119 (9th Cir. 1978); *Pier 1 Imports of Georgia, Inc. v. Wilson*, 529 F. Supp. 239 (N.D. Tex. 1981)).

The statutory purpose likewise should be considered when determining whether those who sell off shares after failing in a hostile takeover attempt are within the coverage of the statute. When the purpose of the section is considered, it is clear that no statutory goal would be accomplished by finding coverage over unsuccessful hostile takeover contestants.

The Congressional purpose behind Section 16(b) could not be plainer. Section 16(b) begins by stating its purpose expressly; it was enacted "[f]or the purpose of preventing the unfair use of information" which an insider may have obtained "by reason of his relationship to the issuer." As this Court stated in *Foremost-McKesson*, 423 U.S. at 244, this purpose does not require that doubts be resolved in favor of Section 16(b) coverage.

In *Kern County* this Court described the climate of hostility which makes it wholly unrealistic to presume, let alone conclusively presume, that an unfriendly takeover contestant misused inside information. The hostility that existed between the target company and the putative "insider" in *Kern County* finds its parallel in the facts of the present case. Like the management of National, Kern County management wanted to avoid its own displacement to the greatest extent possible, and took immediate and vigorous steps to frustrate the efforts of Occidental to gain control. Like the management of National, Kern County repeatedly communicated with its stockholders to vilify Occidental and to compare its merger offers unfavorably with those of management's favorite. Like the management of National, Kern County management refused to enter into discussions with Occidental and concluded an agreement to effect a defensive merger with another company.

In language equally applicable to Texas International, this Court found it "totally unrealistic," 411 U.S. at 596, to presume that Occidental had access to inside information:

> "There is, therefore, nothing in connection with Occidental's acquisition of Old Kern stock pursuant to its tender offer to indicate either the possibility of inside informa-

> tion being available to Occidental by virtue of its stock ownership or the potential for speculative abuse of such inside information by Occidental." *Id.* at 599.

This Court accordingly found that the transaction did not pose a threat of "the evil Congress sought to prevent—the realization of short-swing profits based upon access to inside information." *Id.* at 594.

While this Court in *Kern County* acted in accordance with the statutory purpose and found no liability, it did so on a statutory analysis which may lead to a finding of no liability only in a narrow range of "unorthodox" stock-for-stock transactions. As this case demonstrates, the policy considerations supporting non-liability in *Kern County* are present in a broader class of cases involving defeated contestants in hostile takeover battles who never had access to inside information. Sound policy and accepted principles of statutory construction require that Section 16(b) be read as not applying to such cases.

Indeed, as Judge Friendly observed in his opinion for the Second Circuit in *Kern County,* it is not only unfair but also perverse to apply Section 16(b) to take profits from the defeated takeover contestant, for it was responsible for creating the profits which all shareholders enjoyed:

> "Indeed, if we considered the question here under discussion to be closer than we do, we would be seriously concerned over the policy implications of ruling in appellees' favor. Such a holding would mean that the target of a tender offer not only may solicit a better offer, which is admirable, but also may deliver as bait to the offeree a substantial § 16(b) liability on the part of the very offeror whose initiative aroused the target from its seeming torpor and created a large profit for all stockholders, if the parties can force the transaction through within six months from the latter's purchases. The idea that the person who pointed the company down the road to good fortune should be excluded from the profits realized by all

> other stockholders is repugnant to our sense of equity." *Abrams v. Occidental Petroleum Corp.*, 450 F.2d 157, 163-64 (2d Cir. 1971), *aff'd sub nom. Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973) (footnotes omitted).

Section 16(b) was never intended to accomplish any such result and there is no reason to construe it to do so.

The question presented by this petition is whether treatment of defeated takeover contestants under Section 16(b) may be placed on a sound policy basis consistent with the usual norms of judicial interpretation of statutes and without harm to the benefits of "automatic" enforcement. We respectfully submit that this question is worthy of consideration by this Court.

II. PAN AM, THE SUCCESSFUL TAKEOVER CONTESTANT, IS ESTOPPED FROM USING SECTION 16(b) TO OBTAIN A WINDFALL DISCOUNT ON THE PRICE PAN AM AGREED TO PAY TEXAS INTERNATIONAL FOR ITS SHARES

Pan Am agreed to buy 790,700 shares from Texas International for $50 per share. The effect of applying Section 16(b) to this transaction would be retroactively to reduce the price on 121,000 of these shares to approximately $40.50 per share, or a total reduction of nearly $1,150,000. There is absolutely no policy justification under Section 16(b) for giving this money back to Pan Am. Nevertheless, the panel majority below believed that this result was compelled by cases refusing to permit estoppel or other equitable defenses in Section 16(b) actions.

While equitable defenses properly have been rejected in cases where there were innocent minority shareholders who would benefit from recovery, consideration of equitable defenses is entirely appropriate where, as here, the interests of innocent minority shareholders are not implicated.

Section 16(b), which treats certain insiders as fiduciaries and requires them to account to their corporations for profits on

specified transactions, is a statutory codification of the equitable doctrine of restitution. *See, e.g., American Standard, Inc. v. Crane Co.*, 510 F.2d 1043, 1060 (2d Cir. 1974), *cert. denied*, 421 U.S. 1000 (1975); *Gratz v. Claughton*, 187 F.2d 46, 49 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951) (Learned Hand, C.J.). *Compare* 1 G. Palmer, *The Law of Restitution* § 2.11, at 141 (1978) *with Stock Exchange Regulation, Hearing Before the Committee on Interstate and Foreign Commerce of the House of Representatives on H.R. 7852 and H.R. 8720*, 73d Cong., 2d Sess., at 133 (Feb. 21, 1934) (statement of Thomas G. Corcoran). This Court has stated repeatedly that absent unmistakable Congressional intent to eliminate equitable discretion, a federal court given statutory authority to impose an equitable remedy retains the full discretion of a court of equity and may grant or withhold relief as equity demands. *E.g., Hecht Co. v. Bowles*, 321 U.S. 321, 329-30 (1944) (Court had equitable discretion to refuse injunction even though statute provided that injunction "shall be granted" upon specified showing); *Mitchell v. Robert DeMario Jewelry, Inc.*, 361 U.S. 288, 291-92 (1960); *Porter v. Warner Holding Co.*, 328 U.S. 395, 398 (1946).

Indeed, in a case involving another section of the Securities Exchange Act of 1934 (the "1934 Act"), this Court has recognized equitable estoppel to bar recovery under circumstances strikingly similar to these. In *Bangor Punta Operations, Inc. v. Bangor & Aroostook Railroad*, 417 U.S. 703 (1974), the purchaser of a corporation sought to get a discount on the price it had paid to the old owners by causing the corporation to bring suit against the old owners under Section 10(b) of the 1934 Act and the antitrust laws for damages allegedly suffered by the corporation prior to the purchase. This Court found that the purchaser was barred by equitable estoppel. This Court began by noting that "although the suit purported to be a primary action brought in the name of the corporation, *the real party in interest and hence the actual beneficiary of any recovery*" was the entity that owned more than 99 per cent of the stock. *Id.* at 707 (emphasis added). This controlling entity, like Pan Am, had bought shares from the

defendant at an agreed price, and was seeking "to recover indirectly" money it had paid in the purchase price. *Id.* at 712. This Court held that such attempts are barred by estoppel:

> "In such cases, courts of equity, piercing all fictions and disguises, will deal with the substance of the action and not blindly adhere to the corporate form. Thus, where equity would preclude the shareholders from maintaining an action in their own right, the corporation would also be precluded. It follows that [the 99+% stockholder], the principal beneficiary of any recovery and itself estopped from complaining of petitioners' alleged wrongs, cannot avoid the command of equity through the guise of proceeding in the name of respondent corporations which it owns and controls." *Id.* at 713 (citations omitted).

The inequity of permitting Section 16(b) to be used as a device to obtain a windfall discount on a contract price likewise has been recognized. In *American Standard, Inc. v. Crane Co.*, 510 F.2d 1043, 1061 (2d Cir. 1974), *cert. denied*, 421 U.S. 1000 (1975), having ruled for the defendant on other grounds, the Second Circuit went on to note the unfairness of permitting a successful takeover contestant to use Section 16(b) to obtain a windfall discount on shares he acquires from the defeated adversary:

> "While every § 16(b) recovery may be deemed to partake of windfall there is ample justification in legislative purpose for restoring the recaptured profit to the issuer itself. *There is nothing but sheer windfall, however, in handing it to the successor corporation. That corporation was not in any relationship with [the putative insider] before the merger except that of competitor for control . . . .*" (emphasis added; citations omitted; footnote omitted).

In spite of this, the court below held that it was without power to consider equitable defenses. On the basis of a number of Section 16(b) cases in which equitable defenses were re-

jected, the panel majority concluded that equitable defenses in Section 16(b) cases were insufficient as a matter of law.

The cases do not support this broad rule. In all of the cases relied on below, there were minority shareholders who would have enjoyed the benefit of a Section 16(b) recovery. It is these minority shareholders for whose protection Section 16(b) was enacted. The statute seeks to prevent insiders, who control and manage the corporation, from using their knowledge of the issuer for personal profit. In a case where there are outside minority shareholders who would benefit from a Section 16(b) recovery, it would clearly be inappropriate to permit an "insider" Section 16(b) defendant to establish an estoppel based on the conduct of insider management, with whom the Section 16(b) defendant presumptively is closely identified. All the cases relied on by the courts below for the proposition that equitable defenses could not be recognized involved innocent outside minority shareholders; to the extent that the opinions in the cases explain their holdings, they uniformly point to the minority shareholders for whose benefit the statute was intended and who were innocent of any conduct giving rise to an estoppel. *Magida v. Continental Can Co.*, 231 F.2d 843, 846 (2d Cir.), *cert. denied*, 351 U.S. 972 (1956) ("the policy of the statute is to protect minority stockholders"); *Cutler-Hammer, Inc. v. Leeds & Northrup Co.*, 469 F. Supp. 1021, 1023 (E.D. Wis. 1979) (statute's objective is to prevent "questionable transactions on the part of insiders to the detriment of minority or outside shareholders"); *Schur v. Salzman*, 365 F. Supp. 725, 733 (S.D.N.Y. 1973) (acts of issuer management could not create estoppel, citing interests of "minority or outside stockholders"); *Marquette Cement Manufacturing Co. v. Andreas*, 239 F. Supp. 962, 966 (S.D.N.Y. 1965) ("the policy of the statute is to protect minority stockholders and the public"). Here there is no innocent stockholder who would be deprived of statutory benefit and there is no reason not to consider equitable defenses.

It is clear that the defense of equitable estoppel has been made out. To permit Pan Am to recover would be to allow it

to do just what this Court said would be inequitable in *Bangor Punta*: to "recoup a large part of the price they agreed to pay for their shares," and to gain a "windfall by enhancing the value of its bargain." 417 U.S. at 711, 716. The principles of *Bangor Punta* estop Pan Am from seeking to escape the obligations of its bargain.[3]

Indeed, allowing Pan Am to recover would be, to use Judge Friendly's words, "repugnant" to one's "sense of equity":

— No intended beneficiary of the statute would reap the slightest benefit from recovery. Pan Am has "cashed out" all the minority shareholders in National at a price set long before any possible Section 16(b) claim arose;

— The only beneficiary of any recovery would be Pan Am, which would thereby avoid its contractual obligation to pay $50 per share to Texas International and receive a windfall refund of more than one million dollars;

— The recovery would flow from Texas International, which was kept as an outsider, to Pan Am, which at all relevant times was an insider with at least majority stock ownership of National.

To allow this kind of result in the name of a statute intended to avoid abuses by insiders is to stand Section 16(b) on its head.

We respectfully submit that the question of the proper role of equitable defenses in Section 16(b) cases involving takeover attempts is worthy of review by this Court.

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3 The estoppel does not arise by reason of Pan Am's merger with National during the pendency of this litigation. Rather, it arises because at the time of the sale, Pan Am was already the only shareholder of National with a beneficial interest in a Section 16(b) recovery; all the other shareholders were to be "cashed out" at $50 per share on the merger and would enjoy no benefit from the recovery.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

December 6, 1983

Respectfully submitted,

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APPENDIX

Appendix A

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

No. 82-2215

Sept. 15, 1983

TEXAS INTERNATIONAL AIRLINES,

Plaintiff-Appellant,

—v.—

NATIONAL AIRLINES, INC.,

Defendant-Appellee.

Appeal from the United States District Court for the Southern District of Texas.

Before:

GARZA, POLITZ and JOHNSON,

Circuit Judges.

JOHNSON, *Circuit Judge*:

Texas International (TI) appeals the grant of summary judgment for National Airlines (National) holding TI liable to National under section 16(b) of the Securities Exchange Act of

1934 (the Exchange Act) for the "short swing profits" made on the sale of 121,000 shares of National common stock. Section 16(b), 15 U.S.C.A. § 78p(b) provides, in pertinent part:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months.

The three factors which trigger section 16(b) liability were all present—TI was a ten percent beneficial owner of National that purchased and sold National stock within a six-month period. The district court, therefore, found TI subject to automatic section 16(b) liability to National for the short swing profits TI made on the sale.[1] On appeal, TI argues that equity bars any recovery by National and, in the alternative, that proof of "nonaccess" to inside information should be decisive in a section 16(b) inquiry. This court affirms the grant of summary judgment for National.

Facts

On March 14, 1979, during an attempt by TI to gain control of National, TI purchased 121,000 shares of National common

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1 The district court recognized the narrow "unorthodox" transaction exception to § 16(b) but held that TI's purchase and sale did not fit within this exception.

stock in open market brokerage transactions.[2] On March 14, the date of the purchase, TI was a beneficial owner of more than ten percent of National's common stock. On July 28, 1979, within six months of the March 14 purchase, TI and Pan American World Airways, Inc. (Pan Am) entered into a stock purchase agreement whereby TI agreed to sell 790,700 shares of National common stock to Pan Am at $50 per share.[3] The closing was held on July 30, 1979. Under the matching rules of section 16(b) the 790,700 shares sold by TI on July 28, 1979 are deemed to include the 121,000 shares purchased by TI in March.

On September 6, 1978, National and Pan Am[4] had entered into a merger agreement which provided for the merger of National into Pan Am contingent upon certain conditions and, in connection with the merger, for the exchange by Pan Am of not less than $50 in cash for each share of National common stock, other than the shares held by Pan Am. On May 16, 1979, National stockholders approved the merger agreement dated September 6, 1978, as amended. TI, as a National stockholder, stood to receive $50 per share for its National stock if and when the merger closed. For whatever reason, TI decided not to wait until the merger went through to negotiate for the disposition of its holdings to Pan Am. It was not until

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2 These transactions were as follows: 11,000 shares at $40 per share; 10,000 shares at $40⅛ per share; 4,500 share at $40⅜ per share; 95,500 shares at $40½ per share. The aggregate purchase price for the 121,000 shares was $4,890,687.50, including brokerage commissions of $9,680.00. At all relevant times, National's common stock was listed on the New York and Pacific Stock Exchanges and registered with the Securities and Exchange Commission pursuant to § 12(b) of the Exchange Act.

3 Pursuant to the agreement, Pan Am also agreed to pay TI the sum of $3,000,000 for an option to purchase the remaining 1,309,300 shares owned by TI. In November 1979, Pan Am exercised the option, which is not an issue on appeal.

4 Pan Am Florida, Inc., a subsidiary of Pan Am, was also a party to the agreement.

after the July 28, 1979 sale by TI of its National stock to Pan Am that the National-Pan Am merger was effectuated.

On August 2, 1979, only five days after TI sold its National stock to Pan Am, TI sought declaratory relief[5] that it was not liable to National under section 16(b) for profits realized on the purchase and sale of National common stock. In the alternative, TI sought to reduce its short swing profits by deducting expenses it allegedly incurred in connection with the purchase and sale of its National stock. On September 26, 1979, National counterclaimed, seeking recovery of TI's short swing profits under section 16(b). National moved for summary judgment on November 24, 1980.[6]

On May 11, 1981, the district court granted National's motion in part, finding that TI's purchase and sale of the 121,000 shares of National stock constituted a violation of section 16(b). The district court squarely rejected TI's contention that the control contest situation rendered the transaction at issue "unorthodox" within the meaning of *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 93 S.Ct. 1736, 36 L.Ed.2d 503 (1973). In reaching its conclusion that TI was liable under section 16(b), the district court stated that no court has exempted the type of transaction at issue here—a cash-for-stock transaction—from the automatic application of section 16(b). The court also determined that TI could deduct from the short swing profits for which it was liable, brokerage commissions, transfer taxes, and other incidental expenses incurred in the purchase and sale of the 121,000 shares of National common stock. However, the court ordered TI to submit a breakdown of its claimed expenses incident to the purchase and sale. Following further submissions by both parties, the district court entered an order on March 31, 1982, allowing TI to deduct brokerage commissions and transfer taxes in the amount of $10,117.50 from the short

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5 TI sought declaratory relief pursuant to the Declaratory Judgment Act, 28 U.S.C. §§ 2201 & 2202.

6 By early January 1980, the merger of Pan Am and National had been effectuated. Pan Am became the surviving corporation.

swing profits for which it was liable. The court disallowed, however, all of TI's other requested expense deductions as not incidental to the purchase and sale of the 121,000 shares of National stock. On May 10, 1982, the district court issued its final judgment, dismissing TI's complaint for declaratory judgment and awarding National the sum of $1,149,195 on its counterclaim, together with prejudgment interest and costs.

Equitable Estoppel

In making its argument that equitable estoppel should be allowed as a defense in a section 16(b) action, TI first states the purpose of section 16(b): the evil Congress sought to curb was market speculation by corporate insiders based on abuse of their positions of trust and access to confidential information. TI urges that section 16(b) embodies the equitable remedy of restitution traditionally imposed on fiduciaries. If a fiduciary profits by inside information concerning the affairs of his principal, the fiduciary's profits go to the principal. Given that the section is merely an application of an equitable doctrine, equitable defenses must be allowed, according to TI. TI eschews the section 16(b) cases disallowing equitable defenses as a matter of law by claiming that the instant case is factually distinguishable from those cases. Here, TI urges, there are no innocent outside stockholders of the issuer who need protection. Rather, Pan Am, the only party that would benefit from a recovery, is the very party that has engaged in conduct giving rise to an estoppel. This conduct, according to TI, consisted of Pan Am's involvement in the transaction that created section 16(b) liability at a time when Pan Am was the controlling stockholder of National and had an agreement in place requiring the shareholders to accept $50 for their shares.

The case law uniformly rejects equitable defenses in section 16(b) cases. *See, e.g., Roth v. Fund of Funds, Ltd.*, 405 F.2d 421, 422-23 (2d Cir. 1968), *cert. denied*, 394 U.S. 975, 89 S.Ct. 1469, 22 L.Ed.2d 754 (1969); *Magida v. Continental Can Co.*, 231 F.2d 843, 846 (2d Cir.), *cert. denied*, 351 U.S. 972, 76 S.Ct. 1031, 100 L.Ed. 1490 (1956); *Tyco Laboratories, Inc. v.*

Cutler-Hammer, Inc., 490 F.Supp. 1, 8 (S.D.N.Y.1980); *Cutler-Hammer, Inc. v. Leeds & Northrup Co.*, 469 F.Supp. 1021, 1023 (E.D. Wis. 1979). The facts of this case do not warrant an aberration from the principle that holds equitable defenses in section 16(b) cases insufficient as a matter of law. Indeed, the courts have not accepted equitable defenses even in cases where the issuer participated in the transaction or where the transaction giving rise to the profit occurred at the incentive of the issuer itself. *See, e.g., Roth*, 405 F.2d at 422-23; *Magida*, 231 F.2d at 846. Although disgorgement of profits benefits the shareholders of the issuer, the courts do not entertain equitable defenses which could operate to bar recovery by these shareholders. This Court is not disposed to create an exception to the disallowance of equitable defenses in section 16(b) cases based on the mere difference that in this instance Pan Am, who participated in the section 16(b) transaction, was a shareholder of the issuer (National) who subsequently merged into its shareholder (Pan Am). Allowance of equitable defenses in section 16(b) cases would only serve to thwart the remedial purpose of the statute.

TI places great reliance in a recent case of this Circuit, *Regional Properties v. Financial & Real Estate Consulting Co.*, 678 F.2d 552 (5th Cir. 1982) for the proposition that equitable remedies created by the federal securities laws may be barred by equitable defenses. *Regional Properties* held that a defendant in a suit brought under section 29(b) of the Exchange Act may invoke traditional equitable defenses. *Regional Properties*, however, is of no avail to TI in this section 16(b) case. The question this Court faced in *Regional Properties* was whether real estate developers were entitled to rescind their agreements with the broker under the contract-voiding provisions of section 29(b) of the Exchange Act. An action for rescission of a contract is by its very definition equitable in nature. In the instant case, the question before this Court is not whether the contract between TI and National was void, but whether the profits which were obtained by TI were precluded by § 16(b) and were recoverable by National under the provisions of the statute. Indeed, the reasons this Court gave for allowing

equitable defenses in section 29(b) actions are inapposite to the section 16(b) action before the Court. The first rationale used in *Regional Properties* was that, historically, a suit to void a contract sounds in equity and that actions to void a securities broker's contract are therefore equitable in nature. The case before this Court is not an action to rescind a contract—it is an action to disgorge precluded profits. The second rationale used in *Regional Properties* was that Supreme Court statements favored allowing equitable defenses in section 29(b) actions. In *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 90 S.Ct. 616, 623, 24 L.Ed.2d 593 (1970), the Supreme Court in dictum acknowledged the availability of one equitable defense, *in pari delicto*, in a section 29(b) action. Additionally, in *Transmerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 100 S.Ct. 242, 246-47, 62 L.Ed.2d 146 (1979), the Supreme Court in dictum noted with approval the general reading of section 29(b)-type provisions by the lower federal courts as "implying an equitable cause of action for rescission. . . ." But not even in dicta has the Supreme Court made statements favoring the allowance of equitable defenses in section 16(b) actions. Moreover, this Court in *Regional Properties* opted to allow all the traditional equitable defenses in section 29(b) actions because "virtually all other courts that have decided this issue" have held that equitable defenses are available. On the other hand, the only courts that have addressed the issue in the context of section 16(b) have rejected the allowance of equitable defenses. In sum, none of the reasons justifying this Court's decision in *Regional Properties* to allow equitable defenses in section 29(b) actions is present in the instant case.

Finally, this Court's decision to allow equitable defenses in *Regional Properties* was consistent with the facts of that case. There, the broker had represented to the plaintiff-developers that he was a knowledgeable financial consultant and expert in the tax and legal aspects of limited partnerships and in federal and state securities laws. In fact, however, he was a disbarred attorney who was not registered as a broker, who was inexperienced in limited partnerships, and who was ignorant of federal securities law requirements for either private place-

ments or public offerings of limited partnership interests. Significantly, TI makes no claim of misrepresentations or nondisclosures on the part of Pan Am in this case. Indeed, even were this Court to allow equitable defenses, this Court is unconvinced that the equities favor TI. Fully anticipating both the merger and the possible—if not probable—applicability of section 16(b),[7] TI voluntarily entered into the transaction with Pan Am. TI appears to have made a considered and calculated business judgment in its purchase and sale of its National shares, and to have derived therefrom a substantial profit. Indeed, were this Court to allow TI to escape section 16(b) liability, the result would be a pure windfall to TI. TI, which voluntarily decided to sell its shares to Pan Am before the merger closed, benefited from the use of the sales proceeds during the remaining portion of the statutory period. The facts of the instant case, hardly akin to the facts in *Regional Properties*, supply no motivation for the allowance of equitable defenses in a section 16(b) action.

A Standard of Nonaccess to Inside Information

TI urges this Court to create an exception to automatic section 16(b) liability in cases where a defendant can prove that, notwithstanding its ownership of over ten percent of the stock of the issuer, the defendant had no access to inside information concerning the issuer. According to TI, the classic example of such a case is a sale of stock in the hostile takeover context. Application of section 16(b) in this type of case, argues TI, does not serve congressional goals—Congress intended short-swing profits to be disgorged only when the particular transaction serves as a vehicle for the realization of these profits based upon access to inside information.

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7 TI states that its negotiations with Pan Am began only after Pan Am became a 51% shareholder of National and could thereby force shareholder approval of the 1978 merger agreement. Furthermore, TI filed its complaint for declaratory relief on August 2, 1979, five days after its sale of the 121,000 National shares.

TI's argument is unsupported by the legislative history of section 16(b). Although the abuse Congress sought to curb was speculation by stockholders with inside information, "the only method Congress deemed effective to curb the evils of insider trading was a *flat rule* taking the profits out of a *class of transactions* in which the possibility of abuse was believed to be intolerably great." *Kern County*, 93 S.Ct. at 1473 (emphasis added). In explaining the necessity for a "crude rule of thumb" to Congress, Thomas Corcoran, a principal draftsman of the Act, stated: "You have to have a general rule. In particular transactions it might work a hardship, but those transactions that are a hardship represent the sacrifice to the necessity of having a general rule." Hearings on Stock Exchange Practices before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess., 6557 and 6558 (1934). The Supreme Court explained the necessity for the flat rule or "objective approach" of the statute in *Reliance Electric Company v. Emerson Electric Company*, 404 U.S. 418, 92 S.Ct. 596, 599, 30 L.Ed.2d 575 (1972) *quoting Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir. 1970):

> In order to achieve its goals, Congress chose a relatively arbitrary rule capable of easy administration. The objective standard of Section 16(b) imposes strict liability upon substantially all transactions occurring within the statutory time period, regardless of the intent of the insider or the existence of actual speculation. This approach maximized the ability of the rule to eradicate speculative abuses by reducing difficulties in proof. Such arbitrary and sweeping coverage was deemed necessary to insure the optimum prophylatic effect.

On the basis of legislative history, the court in *Tyco*, 490 F.Supp. at 5-6, rejected the very argument advanced by TI here—that the necessary predicate to section 16(b) liability is access to inside information.

> A review of the legislative history indicates, . . . that Congress specifically envisioned a statutory scheme which imposes automatic liability on any and all ten percent

> shareholders who buy and sell an issuer's securities within a six-month period, irrespective of whether they had access to or misused inside information . . . Moreover, the argument that the preamble to section 16(b), which states that the statute was enacted "[f]or the purpose of preventing the unfair use of information which may have been obtained by [a] beneficial owner, director, or officer by reason of his relationship to the issuer", indicates that Congress did not intend section 16(b) to apply in absolute fashion to transactions where there was no access to inside information, has long been rejected by courts called upon to interpret the Act. . . . [I]f Congress intended that only profits derived by those who had access to inside information were to be recoverable under the Act, it would have been simple enough to say so. It is apparent that Congress selected such a broad, harsh mechanism because it recognized that in no other way could the purpose of the statute be fully implemented and the potential abuses of insider trading effectively controlled.

This Court is in agreement with the statements of legislative purpose as expressed by the *Tyco* court and by the Supreme Court in *Emerson Electric* and *Kern County*—the mechanical application of section 16(b) to the specified class of transactions is necessary in order to guarantee that the abuse at which the statute is aimed will be effectively curbed.

In *Kern County* the Supreme Court approved an extremely narrow exception to the objective standard of section 16(b). The Court held that when a transaction is "unorthodox" or "borderline," the courts should adopt a pragmatic approach in imposing section 16(b) liability which considers the opportunity for speculative abuse, i.e., whether the statutory "insider" had or was likely to have access to inside information.

TI engages in an analogy between the hostile and adversary situation that existed between the target company and the putative insider in *Kern County* and the adversary relationship between TI and National in the instant case.[8] Even assuming

8 In its brief, TI constructs this analogy as follows:

the alleged parallelism between the adversary situations in the two cases and assuming that TI could prove that it neither had nor was likely to have access to inside information by virtue of its statutory "insider" status, no valid basis for an exception to section 16(b) liability on these facts is perceived. The Supreme Court in *Kern County* inquired into whether the transaction had the potential for abuse of inside information only because the transaction fell under the rubric of "unorthodox" or "borderline."[9] In *Kern County*, Occidental, a shareholder in Kern County Land Company (Old Kern) converted its shares in Old Kern into shares of the acquiring corporation pursuant to a merger. The Supreme Court clearly distinguished the unorthodox transaction—a conversion of securities—before it from the traditional cash-for-stock transaction in the instant case: "traditional cash-for-stock transactions . . . are clearly within the purview of § 16(b)."[10] *Kern County*, 93 S.Ct. at 1744.

The hostile and adversary situation that existed between the target company and the putative "insider" in *Kern County* is paralleled to a remarkable degree in the facts of the present case. Like the management of Old Kern, National management wanted to avoid its own displacement to the greatest extent possible, and took immediate and vigorous steps to frustrate the efforts of Texas International to gain control. Like the management of Old Kern, National management repeatedly communicated with its stockholders to vilify Texas International and to compare its merger offers unfavorably with those of management's favorite, Pan Am. Like the management of Old Kern, National management refused to enter into discussions with Texas International and concluded an agreement to effect a defensive merger with another company. As in *Kern County* and in accordance with the recognized pattern in unfriendly takeover situations, Texas International, as the disfavored and ultimately losing bidder for control, far from being treated as an insider, was treated as an enemy.

9 The Court, in a nonexhaustive list, enumerated certain transactions which are unorthodox: stock conversions, exchanges pursuant to mergers and other corporate reorganizations, stock reclassifications, and dealings in options, rights, and warrants. *Kern County*, 93 S.Ct. at 1744 n. 24.

10 The court in *Tyco Laboratories*, 490 F.Supp. at 6-7, stated:

Nowhere in *Kern County*, however, did the Supreme Court state or suggest that a "control contest type of situation" makes a securities

TI lays frontal attack on the unorthodox transaction test as fundamentally flawed, principally because the form of consideration received—cash or stock—has nothing to do with whether inside information was or might have been used. What this attack fails to consider, however, is the significance of the factor of voluntariness in the Supreme Court's decision. The Court's sole concern was not that cash-for-stock sales present a greater opportunity for abuse of inside information than do stock-for-stock sales. Rather, language in the Supreme Court's opinion indicates that traditional cash-for-stock sales were excluded from the concept of unorthodox transactions because of their voluntary nature:

> The critical fact is that the exchange took place and was required pursuant to a merger. . . .
>
> Occidental could, of course, have disposed of its shares of Old Kern for cash before the merger was closed. Such an act would have been a section 16(b) sale and would have left Occidental with a prima facie section 16(b) liability . . . .
>
> But the *involuntary nature* of Occidental's exchange, when coupled with the absence of the possibility of speculative abuse of inside information, convinces us that section 16(b) should not apply to transactions such as this one.

Id. at 1747 (emphasis added). In the instant case, TI voluntarily entered into the stock purchase agreement with Pan Am before the National-Pan Am merger was effectuated. Despite the alleged lack of access to inside information and therefore the possibility of speculative abuse, the volitional character of the exchange is sufficient reason to trigger applicability of the

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transaction "unorthodox." On the contrary, what the Supreme Court actually stated is that a "cash-for-stock" transaction is orthodox and results in automatic section 16(b) liability.

Moreover, . . ., no case either before or after *Kern County* has exempted cash-for-stock transactions from the automatic application of section 16(b). . . .

language of section 16(b).[11] For whatever reason, after the National-Pan Am merger had been approved, TI decided to take the initiative for the course of subsequent events into its own hands rather than wait for the merger to become accomplished. These circumstances do not warrant the creation of an exception to automatic section 16(b) liability.

Calculation of Short Swing Profits

In calculating the short swing profits for which TI was held liable, the district court allowed TI to deduct brokerage commissions and transfer taxes[12] incurred in the purchase and sale of TI's 121,000 shares of National common stock. On appeal, TI complains of the district court's disallowance of the various other expenses by which it sought to reduce the amount of its profit. TI sought deductions for borrowing and interest costs connected with its purchase and holding of the shares. These expenses consisted of costs related to the margin loan in connection with the original purchase of the 121,000 shares[13] and an allocated portion of the public offering used by TI to refinance the initial borrowing.[14] TI also sought deductions for various legal, investment banking, and other consulting fees.[15]

11 In finding an exchange of stock pursuant to a merger not to have been a "sale" for purposes of § 16(b), the Court in *American Standard, Inc. v. Crane Co.*, 510 F.2d 1043, 1056 (2d Cir.1974), *cert. denied*, 421 U.S. 1000, 95 S.Ct. 2397, 44 L.Ed.2d 667 (1975), considered the nonvolitional character of the exchange.

12 These expenses amounted to $10,117.50. TI was therefore allowed to deduct this amount from the $1,159,312.50 in short swing profits.

13 These costs are enumerated as follows: (1) $40,723 interest paid on the money borrowed to purchase the 121,000 shares (the margin loan); (2) a commitment fee of $1,771 paid to the entity from which plaintiff obtained a portion of the margin loan; (3) $10,822 in fees paid to the banks' attorneys in connection with the margin loan.

14 The allocated portion, $238,698, represented the portion of the proceeds of the public offering that was used to refinance the 121,000 shares.

15 These costs are enumerated by the district court in its order of March 31, 1982, as follows:

This Court agrees with the district court that these costs represented nontransactional expenses which were not incidental to the purchase and sale of the 121,000 shares of National common stock.

In considering the calculation of profit under section 16(b) the need has been recognized to "squeeze every possible penny of profit out of such transactions" in order to effectuate the remedial purpose of the statute. *Blau v. Lehman,* 286 F.2d 786, 791 (2d Cir. 1960), *aff'd,* 368 U.S. 403, 82 S.Ct. 451, 7 L.Ed.2d 403 (1962) *citing Smolowe v. Delendo Corp.,* 136 F.2d 231, 239 (2d Cir.), *cert. denied,* 320 U.S. 751, 64 S.Ct. 56, 88 L.Ed. 446 (1943). The Court in *Blau,* 286 F.2d at 791, reaffirmed this principle even though in the case before it, no confidential information had been improperly used. The Court specifically noted that the stock acquisition in that case was voluntary. *Id.* at 792.

This Court is not persuaded by the argument that accounting principles, or any other approach designed to portray profit in a realistic way, would allow a deduction of the claimed expenses in computing the profit made on the transaction. The Court is obliged to construe the term "profit" in a federal statute designed to impose strict liability on particular parties

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(1) voting trust administration fees of $374 which were incurred with respect to the National shares owned by plaintiff;

(2) investment banking fees totalling $43,214;

(3) the sum of $3,666, constituting the cost of public relations, management and transportation consultants, consultation and testimony relating to the Civil Aeronautic Board proceeding to acquire National, and accounting;

(4) legal fees of $91,223;

(5) commitment fees totalling $18,343;

(6) miscellaneous disbursements of $1,926 which include the cost of printing and supplies, the unidentified expenses of certain individuals employed by plaintiff, computer services cost, transcripts costs, news clipping costs, newswire services cost, courier services, the cost of a "Texas Delegation breakfast"; and,

(7) the sum of $23,000 which constitutes estimated management and clerical time spent in support of the margin loan, floating rate note offering and the effort to acquire National from March 14 through July 30, 1979.

who make short swing profits within the proscribed period. As the Court in *Blau* stated: "We are not . . . computing profits in accordance with what might be the custom of traders and speculators in the stock market. We are construing a federal statute . . . ." *Id.* Indeed, the method of computing profit within section 16(b) can result in a "profit," albeit a theoretical one, even though the short swing trader has suffered a net loss from his trading during the period.[16]

In *Lane Bryant, Inc. v. Hatleigh Corp.*, 517 F.Supp. 1196, 1202 (S.D.N.Y. 1981), the defendant sought to reduce the amount of profit made by (1) administrative overhead expenses, (2) interest on the loans secured to enable defendant to finance the stock purchases, (3) office overhead, and (4) lawyers' fees and costs of litigation. The Court rejected all of these proposed deductions:

> None of these attempted deductions is appropriate in calculating the short-swing profits. The profits on the purchases and sales are not to be equated with the costs to the defendant of doing business, nor conducting litigation seeking the control of the enterprise. It would be inappropriate to permit the bank's administrative charges for handling the defendant's account or its interest charges on loans which the defendant secured to enable it to finance the purchases to reduce the profit on the trades.

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16 The "lowest-in-highest-out" rule used to calculate § 16(b) profit by the matching of particular purchases and sales within the six-month period can result in a theoretical profit. Professor Loss gives the following example:

> In one case the defendant suffered a judgment of some $300,000 as a result of the application of the rule to various six-month periods from December 10, 1944, the date when he had first become a 10 percent owner, to December 3, 1947, when he had ceased to be such a holder, although his trading during those three years had resulted in an actual loss to him of over $400,000. Judge Learned Hand observed that this "crushing" liability "should certainly serve as a warning, and may prove a deterrent."

II L. Loss, Securities Regulation ch. 6C(f), 1063-64 (2d ed. 1961) (footnotes omitted).

> The profits contemplated by the statute are profits from the purchase and sale of the securities and not any costs such as bank charges, office overhead or collateral litigation which a party seeking control incurs. To permit the deductions claimed would be to encourage the type of transactions from which the statute squeezes all profit to be made on the basis of third party financing of the transactions which by itself would merely multiply the problems sought to be reached by Section 16(b).

Id.

In the instant case, the district court disallowed what has been characterized as "takeover expense deductions" and permitted TI to deduct only those expenses truly incidental to the transaction—brokerage commissions and transfer taxes.

Conclusion

This Court finds no valid justification for deviation from the express terms of section 16(b) or the case law interpreting it. The judgment of the district court is affirmed.

AFFIRMED.

GARZA, *Circuit Judge*, dissenting:

I respectfully dissent. The majority opinion is highly persuasive and its interpretation of *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 93 S.Ct. 1736, 36 L.Ed.2d 503 (1973) is certainly consistent with the "weight" of the law as it exists.

However, due to the particular facts of this case I would extend the rationale of *Kern County, supra.*

Section 16(b) provides that a statutory insider must surrender to the issuing corporation any profit realized from the purchase and sale of an equity security of the issuer within a period less than six months.

The statute itself states that it was enacted "for the purpose of preventing the unfair use of information which may have been obtained by [a statutory insider] . . . by reason of his relationship to the issuer." The statute itself is a strict liability statute designed to deter insiders from exploiting information not generally available to others in order to secure quick profits.

In *Kern County,* supra, the Supreme Court recognized that the nature of certain "unorthodox" transactions were such that a narrow exception to the otherwise strict liability rule was permissible. The facts of this case, I believe, would bring it within that narrow exception to the otherwise strict liability rule.

Texas International (TI) correctly argues that there are many similarities between the present case and that presented to the Supreme Court in *Kern County.* The putative "insider" in both cases was a party seeking to institute a "hostile" takeover of the issuer. It is evident from the record in this case that in both cases the party seeking takeover had no "inside information" upon which it could obtain short swing profits. In both cases the statutory stockholder failed in its attempt to take over the target company. The Supreme Court recognized in *Kern County* that after the merger agreement was approved, Occidental had no choice but to take action to protect its own interest.

In this case TI moved to protect its own interest when it agreed to sell its stock to the takeover company, Pan American World Airways, Inc. (Pan Am), after it became apparent that TI had lost the takeover battle. Unfortunately for TI, the sale took place forty-eight days before the statutory period had run.

Admittedly, the forced merger present in *Kern County* distinguishes that case from the present one. However, the facts of this case present a scenario which favors extension of the "unorthodox" exception.

Like Occidental, no one can argue that TI actually made use of inside information to obtain any short swing profits. The reason for the existence of § 16(b) is in no way promoted by its

application to the present transaction. Furthermore, TI's sale of stock was to the parent corporation for the purpose of protecting its own interests and cooperating in the merger transaction which Pan Am was attempting to effectuate.

The record clearly evidences that at the time of the sale by TI to Pan Am, no present or past shareholders of National Airlines had in any way been monetarily damaged by TI's purchase and sale of stock. In fact, it can be argued that the attempted takeover of National by TI helped to increase the value of National Airlines' stock. TI did not receive a higher price for the stock than any other shareholder. ALL shareholders of National Airlines received $50 per share.

Application of § 16(b) in this case serves only to permit Pan Am to avoid that portion of its contract with TI in which it agreed to pay $50 per share. The award in this case is nothing more than a "windfall" to Pan Am as the successor of National Airlines.

There is language in *Kern County* which, at first glance, as held by the majority opinion, appears to foreclose TI's present argument. At one point in that opinion the court stated:

> *Although traditional cash-for-stock transactions* that result in a purchase and sale or a sale and purchase within the six-month statutory period *are clearly within the purview of § 16(b)*, the courts have wrestled with the question of inclusion or exclusion of certain "unorthodox" transactions.

TI's sale was clearly a "cash-for-stock" transaction; however, the situation before us, like *Kern County*, involved a hostile takeover which failed. The "hostile" takeover situation is hardly the "traditional cash-for-stock sale" which § 16(b) was designed to encompass. Rather, it is more of a "borderline" or "unorthodox" transaction and the above language can arguably be used to support such a finding.

The majority opinion cites the following language in *Kern County:*

> Occidental could, of course, have disposed of its shares of Old Kern for cash before the merger was closed. Such an

> act would have been a § 16(b) sale and would have left Occidental with a prima facie § 16(b) liability. It was not, therefore, a realistic alternative for Occidental . . . .

in holding that this language forecloses TI's argument; however, it is unclear whether it would have made a difference to the Supreme Court if the disposition of shares had been to the takeover company or a third party.

I agree that if Occidental in *Kern County* or TI in this case had sold its shares after the merger agreement to a third party, § 16(b) would have been clearly implicated. On the other hand, such is not the case if the sale was to the takeover company itself and the statutory insider, TI, received no more than any other shareholder of the issuer. In the case before us, no potential for abuse would have arisen or could arise and it is unclear from the court's statement quoted above, if it was referring to a disposition of shares to a third party or to any party including the takeover company. My view is that the above language need not foreclose TI's argument. TI did what every other shareholder of National Airlines had to do and the fact that it did it forty-eight days before the six-month period expired should not work to the detriment of TI and as a windfall to Pan Am who bought the shares for the price stated in the merger agreement.

In summary then, I would hold that the "spirit" of *Kern County* suggests that in an "unorthodox" transaction as the one before us, where the policies of § 16(b) are in no way implemented (and in fact, where such rule permits a party to void an otherwise legal contract) liability against the statutory "insider" should not be enforced.

Under the facts of the case before us, the hostile takeover scenario is more closely analogous to the "unorthodox" transaction rather than the "traditional" cash-for-stock sale.

Under similar situations I would not make any distinction between a cash-for-stock and a stock-for-stock sale.

Accordingly, I would hold that § 16(b) was not applicable to TI and I would reverse the court below.

Appendix B

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

Civil Action No. H-79-1609

TEXAS INTERNATIONAL AIRLINES, INC.,

v.

NATIONAL AIRLINES, INC.

Alvin M. Owsley, Jr., Baker & Botts, 3000 One Shell Plaza, Houston, Texas 77002, attorney for plaintiff.

David T. Harvin, Vinson & Elkins, 2100 First City National Bank Building, Houston, Texas 77002, attorney for defendant.

MEMORANDUM AND ORDER

Pending before the Court is defendant's motion for summary judgment pursuant to Rule 56,[1] Fed. R. Civ. P. Plaintiff

1 Pursuant to Rule 56, Fed. R. Civ. P., summary judgment can only be granted "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). *See* Kenneth-Murray Corp. v. Boone, 622 F.2d 887 (5th Cir. 1980). Conversely, summary judgment is inappropriate where there exists a genuine issue as to any material fact. *See* Keiser v. Coliseum Properties, Inc., 614 F.2d 406, 410 (5th Cir. 1980); Munoz v. International Alliance of Theatrical Stage Employees and Moving Picture

has filed a memorandum in opposition to the motion to which defendant has replied. After careful consideration of defendant's motion and the memoranda filed by both parties, the Court grants defendant's motion for summary judgment in part and denies it in part, but refrains from ruling on the amount of damages to which defendant is entitled until such time that a more definite determination of damages can be made.

Introduction

There is no dispute as to the following essential facts. On March 14, 1979, during an attempt by Texas International Airlines, Inc., (hereinafter Texas International) to gain control of National Airlines (hereinafter National), Texas International purchased 121,000 shares of the common stock of National in open market brokerage transactions for the following prices: 11,000 shares at $40 per share, 10 [sic] shares at $40 1/8 per share, 4,500 shares at $40 3/8 per share, and 95,500 shares at $40 1/2 per share, for an aggregate price of $4,890,687.50 including brokerage commissions of $9,680.[2] At the time of the purchase, Texas International was a beneficial owner of more than ten percent of National's common stock.[3]

Machine Operators, 563 F.2d 205, 207 n.1 (5th Cir. 1977). The party seeking summary judgment has the burden of proving the absence of a genuine issue of material fact. Adickes v. S. H. Kress and Co., 398 U.S. 144 (1970); United States v. An Article of Food Consisting of 345/50-Pound Bags, 622 F.2d 768 (5th Cir. 1980). In reviewing the pleadings, depositions, answers to interrogatories, admissions, and affidavits to determine whether a genuine issue of material fact exists, a court must resolve all reasonable doubt in favor of the party opposing the motion for summary judgment. United States v. An Article of Food Consisting of 345/50-Pound Bags, *supra*.

2 At all relevant times, National's common stock was a class of equity securities listed on the New York and Pacific Stock Exchanges and registered with the Securities and Exchange Commission pursuant to § 12(b) of the Act, 15 U.S.C. § 77 *et seq.* (1933).

3 At the time of the Texas International's purchase of National common stock on March 14, 1979, all shares of National common stock

On June 29, 1979, Texas International received from National a cash dividend of $15,125 with respect to the 121,000 shares of National common stock.

On July 28, 1979, Texas International and Pan American World Airways, Inc. (hereinafter Pan Am) entered into an agreement pursuant to which Pan Am agreed to purchase from Texas International, 790,700 shares of National common stock at $50 per share. Pan Am agreed further to pay Texas International the sum of $3,000,000 for an option to purchase the remaining 1,309,300 shares owned by Texas International. In November, 1979, Pan Am exercised its option and purchased the remaining National common stock owned by Texas International for $65,465,000.00.

On August 2, 1979, Texas International commenced the instant action seeking declaratory relief pursuant to the Declaratory Judgment Act, 28 U.S.C. § 2201 (1978) and § 2202 (1942). In its complaint, Texas International requests that the Court declare "that [Texas International] is not liable to National for profits realized on the purchase and sale of National common stock during the six month period [ending] July 30, 1979." Complaint For Declaratory Judgment, *Texas International Airlines, Inc. v. National Airlines, Inc.*, No. H-79-1609 (S.D. Tex. Aug. 2, 1979). Alternatively, Texas International requests the Court to declare that if it is liable to National for the profits realized on the purchase and sale of the National stock during the six month period, then the Court should deduct from the profit the expenses incurred by Texas International in connection with the purchase, holding and sale

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owned by Texas International were held by United States Trust Company of New York as voting trustee under a voting trust agreement between Texas International and the voting trustee. The voting trust was established in order to comply with Section 408 of the Federal Aviation Act of 1958, 49 U.S.C. § 1378 (1978), which required that the voting trustee vote the shares of National common stock held in trust proportionally in accordance with all other votes cast, except as the Civil Aeronautics Board might otherwise permit or direct. The voting trust, however, was not irrevocable and Texas International retained the economic incidents of ownership and the power to dispose of its stock.

of the shares. National has filed a counterclaim requesting the Court award it the value of plaintiff's alleged section 16(b) short swing profits. In addition to the difference between the sales price and the purchase price of the 121,000 shares, National seeks the cash dividends Texas International received for such shares during the relevant six month period. Finally, contending that a sale of the 2,100,000 shares of National common stock owned by Texas International occurred on July 28, 1979, defendant seeks a pro rata portion of the option fee of $3,000,000 found by the Court to be attributable to the 121,000 shares.

Liability

Section 16(b) was designed to discourage the use of inside information by corporate insiders who trade in the stock of the corporation. *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 591-92 (1973). It was recognized, however, that proof that trading was based on inside information and was purely for speculative, rather than investment purposes, would be hard to come by. But it was realized also that "since the speculative advantage to be gained from inside information is usually short lived", *Provident Securities Co. v. Foremost-McKesson, Inc.*, 423 U.S. 232 (1976), a short turnover in stock was far more likely to be a speculative adventure to capitalize on inside information than a pair of widely spaced transactions. Congress thus overcame this serious obstacle to effective remediation by engaging in the conclusive presumption that two trades by an insider within six months of each other were speculative and based on inside information.[4] As the Supreme Court stated:

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4 The legislative history of the section reveals that this is the proper interpretation of the purpose and rationale of the six month rule in section 16(b). The original version of what was to become section 16(b) of the Securities Exchange Act of 1934 provided, in pertinent part, as follows:

> It shall be unlawful for any [insider] (1) to purchase any . . . security *with the intention or expectation* of selling the same security within six months; and any profit made by such person on any transaction in

> In order to achieve its goals, Congress chose a relatively arbitrary rule capable of easy administration. The objective standard of Section 16(b) imposes strict liability upon substantially all transactions occurring within the statutory time period [six months]; regardless of the intent of the insider or the existence of actual speculation. This approach maximized the ability of the rule to eradicate speculative abuses by reducing difficulties in proof. Such arbitrary and sweeping coverage was deemed necessary to insure the optimum prophylactic effect.

Reliance Electric Co. v. Emerson Electric Co., 404 U.S. 418, 422 (1972), *quoting Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971).

In response to a series of cases requiring the application of section 16(b) to transactions which were not classic purchases and sales for cash, e.g., stock mergers, stock options, stock conversions, the Supreme Court applied a more pragmatic and subjective approach. The Court held that when a transaction is "unorthodox" and not clearly within the reach of the statute, an inquiry into whether the transaction presents an opportu-

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> . . . a . . . security extending over a period of less than six months shall inure to and be recoverable by the issuer, *irrespective of any intention or expectation* on his part *in entering into such transaction* of holding the security purchased for a period exceeding six months.

Hearings on S. 56 and S. 97 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess., Pt. 15, at 6430 (1934) (emphasis added). Thomas Corcoran, a spokesman for the draftsmen and proponent of the bill, explained to the Senate Committee on Banking and Currency the rationale behind the section's rule:

> You hold the director, irrespective of any intention or expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended at the time he bought, to get out on a short swing.

Hearings on S. 56 and S. 97 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess., Pt. 15, at 6556-57. *See, e.g.*, Kern County Land Co. v. Occidental Petroleum Corp., *supra*, at 592; Bershad v. McDonough, *supra*; Blau v. Lamb, *supra*; Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943), *cert. denied*, 320 U.S. 741 (1943).

nity for speculative abuse should be made before section 16(b) liability is imposed:

> The statutory definitions of "purchase" and "sale" are broad and, at least arguably, reach many transactions not ordinarily deemed a sale or purchase. In deciding whether borderline transactions are within the reach of the statute, the court has come to inquire whether the transaction may serve as a vehicle for the evil which Congress sought to prevent . . . thereby endeavoring to implement congressional objectives without extending the reach of the statute beyond its intended limits. . . . [Because of the liability without fault nature of section 16(b)] the prevailing view is to apply the statute only when its application would serve its goals.[5]

Kern County Land Co. v. Occidental Petroleum Corp., supra, at 593-95. This "subjective" or "pragmatic" approach was designed to mitigate the harshness of the application of section 16(b) absolute liability to situations in which insider speculation on non-public information was impossible.

Plaintiff contends that as its purchase and sale of 121,000 shares of National common stock occurred during a contest for the control of a hostile corporation, the transaction was an "unorthodox" transaction within the Supreme Court's narrow exception to section 16(b) liability. Plaintiff premises its contention upon the following contested allegations:

> In the days after Texas International's announcement that it owned 9.2% of National common stock, National initiated several actions for the purpose of hindering and

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5 Under section 3(a) (14) of the Act, 15 U.S.C. § 78c(a)(14)(1933), the sales covered by section 16(b) are defined broadly to include "any contract to sell or otherwise dispose of" any security. The construction of the terms "sale", as well as "purchase" is a matter of federal law, and not contract law, *Icherepnin v. Knight*, 389 U.S. 332, 337-338 (1967), and should be construed in a manner which will effectuate section 16(b)'s prophylactic purpose of preventing speculation. SEC v. National Securities, Inc., 393 U.S. 453, 467 (1969); Bershad v. McDonough, *supra*.

delaying the efforts of Texas International in acquiring control of National:

(A) Induced the Secretary of State of Florida to commence a lawsuit (which was soon dismissed) against Texas International;

(B) encouraged the Enforcement Division of the Securities and Exchange Commission to investigate Texas International;

(C) asked the Civil Aeronautics Board ("CAB") to refuse to consider Texas International's request for permission to seek a merger with National and sought to persuade the CAB to take enforcement action against Texas International;

(D) negotiated and signed an agreement, subject to CAB and stockholder approval, to effect a defensive merger with Pan Am.

Brief for Plaintiff at 3, *Texas International Airlines, Inc. v. National Airlines, Inc.*, No. H-79-1609 (S.D. Tex. Dec. 22, 1980). Consistent with this asserted pattern of overt hostility, plaintiff alleges further that National's management refused to have any contact with Texas International. Accordingly, plaintiff contends that insofar as the sale transaction of the 121,000 shares of National common stock was unorthodox with no possibility of speculative abuse, Texas International is not liable under section 16(b).

Plaintiff's contention that the existence of a control contest type of situation renders the transaction at issue here "unorthodox" within the meaning of *Kern County Land Co. v. Occidental Petroleum, supra*, and, accordingly, warrants an inquiry into whether Texas International had access to inside information on July 28 when Texas International sold 790,700 shares of National Common stock is without merit. The issue involved in *Kern County Land Co. v. Occidental Petroleum, Inc., supra*, was whether a section 16(b) "sale" occurs "when the target of the tender offer defends itself by merging into a third company and the tender offeror then exchanges its stock

for the stock of the surviving company and also grants an option to purchase the latter stock that is not exercisable within the statutory six-month period." *Id.*, at 584. In reviewing the purposes of section 16(b), the Court stated: "[t]raditional cash-for-stock transactions that result in a purchase and sale or a sale and purchase within the six month statutory period are clearly within the purview of § 16(b). . . ." *Id.* at 593. The Supreme Court stated then that in interpreting the terms "purchase" or "sale" in unorthodox or "borderline" transactions, a "pragmatic approach" to section 16(b) was appropriate. *Id.* at 594 n. 26. The Court went on to define "unorthodox" as encompassing "those transactions not ordinarily deemed a sale or purchase," and in a footnote listed those transactions to which the term had been applied: "stock conversions, exchanges pursuant to mergers and other corporate reorganizations, stock classifications, and dealings in options, rights, and warrants." *Id.* at 593 n.24. Nowhere in the Court's decision, however, does the Court indicate that a "control contest type of situation" would render a stock transaction "unorthodox". On the contrary, the court stated that a cash-for-stock transaction is "orthodox" and results in section 16(b) liability.[6] *Id.* at 593.

Furthermore, as correctly pointed out by defendant, there are no cases which have exempted cash-for-stock transactions from the automatic application of section 16(b). Thus, the Court is left unpersuaded that deviation from the express terms of the statute or case law is warranted in the present cause. Accordingly, the Court concludes that as the purchase of 121,000 shares of National common stock on March 14, 1979 and the subsequent sale of 790,700 shares on July 28, 1979 occurred within the statutory six month period, Texas Interna-

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6 In discussing the limited exception to automatic liability under section 16(b), the Supreme Court in Kern County Land Co. v. Occidental Petroleum, Inc., *supra*, stated that had Occidental disposed of its shares of Old Kern for cash before the merger was closed, "[s]uch an act would have left Occidental with a prima facie § 16(b) liability." *Id.*, at 600.

tional is subject to automatic section 16(b) liability and is liable to National for the "short swing profits" made on the sale of the 121,000 shares of National common stock.[7]

Contending that a "sale" of the 2,100,000 shares of National common stock owned by Texas International occurred on July 28, 1979, defendant asserts that it is entitled to a pro rata portion of the three million dollars that Pan Am paid Texas International for an option to purchase 1,309,300 shares of National common stock at a later date. As indicated earlier, Texas International and Pan Am entered into an agreement whereby Texas International agreed to sell to Pan Am 790,700 shares of National common stock at $50 per share. The agreement between the parties further granted Pan Am an option to purchase an additional 1,309,300 shares at $50 per share. Although Pan Am was not obligated to purchase the shares if certain specified conditions were not satisfied, Texas International was bound to transfer the shares upon exercise of

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7 In an effort to avoid section 16(b) liability, Texas International advances several novel arguments based on principles of equity to support its contention that National is barred from recovering "short swing profits" under section 16(b). As the arguments of counsel are contained adequately in their briefs, the Court will refrain from repeating those arguments in this Order. The Court, however, has carefully considered these arguments in light of the relevant case law, and concludes that plaintiff's arguments are without merit. Those cases cited in support of the contentions advanced by plaintiff are inapposite to the present case. Further, there are many cases which have held that equitable principles as defenses are insufficient as a matter of law in section 16(b) actions. Roth v. Fund of Funds, Ltd., 405 F.2d 421, 422-23 (2d Cir. 1968); Magida v. Continental Can Co., Inc., 231 F.2d 843, 846 (2d Cir. 1956), *cert. denied*, 351 U.S. 972 (1956); Tyco Laboratories, Inc. v. Cutler-Hammer, Inc., 490 F. Supp. 1 (S.D.N.Y. 1980); Cutler-Hammer, Inc. v. Leeds Northrup Co., 469 F. Supp. 1021, 1023 (E.D. Wis. 1979); Schur v. Salzman, 365 F. Supp. 725, 733 (S.D.N.Y. 1973); Allied Artists Pictures Corp. v. Giroux, 312 F. Supp. 450, 451 (S.D.N.Y. 1970); Newmark v. RKO General, Inc., 294 F. Supp. 358, 367 (S.D.N.Y. 1968), *aff'd*, 425 F. Supp. 348 (2d Cir. 1970), *cert. denied*, 400 U.S. 854 (1970); Wolk v. Zlotoff, 285 F. Supp. 650, 655-56 (S.D.N.Y. 1968); Marquette Cement Manufacturing Co. v. Andreas, 239 F. Supp. 962, 966 (S.D.N.Y. 1965); Jefferson Lake Sulphur Co. v. Walet, 104 F. Supp. 20, 23-24 (E.D. La. 1952), *aff'd*, 202 F.2d 433 (5th Cir. 1933), *cert. denied*, 346 U.S. 820 (1953).

the option and tender of the specified purchase price. As compensation for assuming the risk that Pan Am might never exercise the option, Texas International received three million dollars. It is a pro rata portion of this three million dollars that defendant now seeks.

In support of its contention that the option granted to Pan Am on July 28, 1979 was not a sale, plaintiff asserts that the case of *Kern County Land Co. v. Occidental Petroleum, supra*, is again controlling. As stated previously, the Supreme Court in *Kern County* was confronted with the task of determining "whether a 'sale' within the ambit of the statute took place either when Occidental became irrevocably bound to exchange its shares of Old Kern for shares of Tenneco pursuant to the terms of the merger agreement between Old Kern and Tenneco, or when Occidental gave an option to Tenneco to purchase from Occidental the Tenneco shares so acquired." *Id.* at 595. Recognizing that the courts have struggled with the question of whether "unorthodox" transactions such as options to purchase are within the purview of section 16(b), the Court stated that "[t]he statutory definitions of 'purchase' and 'sale' are broad and, at least arguably, reach many transactions not ordinarily deemed a sale or purchase." *Id.* at 594. In determining whether these borderline transactions are within the reach of section 16(b), an inquiry must be made as to whether the transaction may serve as a vehicle for the evil which Congress sought to prevent—short swing speculation by insiders with inside information. *Id.* This inquiry, however, must be reserved for a later date, since the facts upon which plaintiff relies in contending that the execution of the option to purchase was not one in which the possibility for speculative abuse existed are material and contested by the parties. Accordingly, defendant's request that it be awarded as "short swing profits" a pro rata portion of the three million dollars paid by Pan Am for the option-to-purchase must be denied at the present time.

Dividends

Courts often have recognized the recovery of dividends as part of the "short swing profits" recoverable from a corporate insider, *Blau v. Lamb*, 363 F.2d 507, 528 (2d Cir. 1966), *cert. denied*, 384 U.S. 1002 (1967); *Alder v. Klawans*, 267 F.2d 840, 848 (2d Cir. 1959); *Allis-Chalmers Mfg. Co. v. Gulf & Western Industries, Inc.*, 372 F. Supp. 570 (N.D. Ill. 1974), *modified on other grounds*, 527 F.2d 335 (7th Cir. 1975), *cert. denied*, 423 U.S. 1078 (1976); *Marquette Cement v. Andreas*, 239 F. Supp. 962, 968 (S.D.N.Y. 1965); however, such dividends are only recoverable as profits under section 16(b) "when they are inextricably connected to the decision to purchase and sell the shares in question that to allow the insider to retain such dividends would frustrate the purpose of Section 16(b)." *Cutler-Hammer, Inc. v. Leeds & Northrup Co.*, 469 F. Supp. 1021, 1024 (E.D. Wis. 1979), *citing*, *Blau v. Lamb*, *supra* at 528; *Adler v. Klawans*, *supra* at 849. As stated in *Allis Chalmers Mfg. Co. v. Gulf Western Industries, Inc.*, *supra*:

> Experts in the field look upon anticipated dividends as part of the package for which the consideration is paid when the stock is purchased. In addition, dividends are not an element of profit in the sense that they do not result from the purchase and sale of stock, but rather come from the holding of stock. See 45 Va.L.Rev. 1057, 1069 (1959). In the language of the statute dividends logically are not profit. The statute reaches '*profit realized from the purchase and sale*'. Dividends thus are treated by the statute like an operational earning or income. This statutory interpretation reads upon the ordinary thinking about dividends in the market place. Except where they are a matter of special concern, the market price generally is presumed to cover dividends reasonably anticipated. At least to the extent that they regularly are paid, they are considered absorbed in the price paid for the stock.

Id. at 588-89 (emphasis in original).

In addition to the difference between the purchase and sale price of the 121,000 shares of National common stock, National seeks to recover as "short swing profits" the dividends received by Texas International between March 14, 1979 and July 28, 1979. It is uncontested by the parties that on June 29, 1979 National received dividends in the amount of $15,125 in regard to the 121,000 shares.

In the present case, National has neither claimed that Texas International engaged in short-term speculation for the purpose of capturing dividends nor demonstrated that the price per share in the July 28 transaction did not reflect reasonably anticipated profits. Nor do the circumstances surrounding the payment of the dividend or sale of National common stock on July 28 support either of the above. Accordingly, as the Court concludes that the dividends were nothing more than a distribution of earnings, National's request that the June 29 dividends be awarded as "short swing profits" under section 16(b) is denied.

Expenses Incident to the Purchase, Holding and Sale of Securities

After a thorough examination of the case law addressing the issue, the Court concludes that the expenses of a corporate insider in performing a purchase or sale may be deducted from "short swing profits" in section 16(b) cases. *Blau v. Mission Corp.*, 212 F.2d 77, 81 (2d Cir. 1954), *cert. denied*, 347 U.S. 1016 (1954); *Sprague Electric Co. v. Mostek Corp.*, 488 F. Supp. 842 (N.D. Tex. 1980); *Allis-Chalmers Manufacturing Company, supra* at 588; *Arkansas Louisiana Gas Co. v. W. R. Stephens Investment Co.*, 141 F. Supp. 841, 845, 847 (W.D. Ark. 1956). Accordingly, the Court concludes that Texas International may deduct from the "short swing profits" for which it is liable, the brokerage commissions, transfer taxes and other incidental expenses incurred in the purchase and sale of the 121,000 shares of National common stock. *See Sprague Electric Co. v. Mostek Corp., supra* at 846, *see also* 2 Loss, Securities Regulation, 1064 (1961).

Prejudgment Interest

It is well established in cases involving violations of section 16(b), that an award of prejudgment interest lies within the discretion of the trial court and such interest is not awarded as a matter of course. *Blau v. Lehman*, 368 U.S. 403 (1962); *Gold v. Sloan*, 486 F.2d 340 (4th Cir. 1973), *cert. denied*, 419 U.S. 873 (1974); *Blau v. Lamb*, *supra* at 507; *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); *Oliff v. Exchange Intern. Corp.*, 449 F. Supp. 1277 (N.D. Ill. 1978); *Morales v. Gould Investors Trust*, 445 F. Supp. 1144 (N.Y. 1977), *aff'd*, 478 F.2d 1369 (2d Cir. 1978). " '[I]nterest is not recovered according to a rigid theory of compensation for money withheld, but is given in response to considerations of fairness. It is denied when its exaction would be inequitable.' " *Blau v. Lehman*, *supra* at 414, *citing*, *Board of County Commissioners of the County of Jackson v. United States*, 308 U.S. 343, 352 (1939).

In following the aforementioned rule, several courts have declined to award interest upon a showing of good faith on the part of the section 16(b) "insider". *See*, *e.g.*, *Gold v. Sloan*, *supra*; *Sprague Electric Co. v. Mostek Corp.*, *supra*; *Lewis v. Realty Equities Corporation of New York*, 396 F. Supp. 1026 (S.D.N.Y. 1975); *Volk v. Zlotoff*, 318 F. Supp. 864, 867 (S.D.N.Y. 1970). Other courts have denied interest where there has been an unexcused inordinate delay between the section 16(b) violation and the request for relief. *Lewis v. Realty Equities Corporation of New York*, *supra*; *Blau v. Lamb*, *supra*. Yet there are still other cases in which courts have disregarded both factors and awarded interest utilizing the policy behind section 16(b), i.e., "short swing profits" should be awarded regardless of the innocence of the corporate insider. *See Champion Home Builders Co. v. Jeffress*, *supra*; *Schur v. Salzman*, 365 F. Supp. 725 (S.D.N.Y. 1973).

The Court has reviewed fully each of the factors or rationales utilized by courts in awarding interest. The Court concludes, however, that the preferable approach in the instant cause is to employ common sense and pay due respect to

fairness, equity, and the public policy behind the promulgation of section 16(b). After careful consideration of all the circumstances, the Court concludes that to deny the defendant prejudgment interest in the present cause would be inequitable. Accordingly, the Court awards prejudgment interest at the rate normally awarded by the courts in the State of Texas.[8] *See generally* Tex. Rev. Civ. Stat. Ann. art. 5069-1.03 (Vernon 1971).

Conclusion

In summary, the Court concludes that as the purchase and sale of 121,000 shares of National common stock occurred within the statutory six month period, Texas International is subject to automatic section 16(b) liability and is liable to National for the "short swing profits" made on the purchase and sale of the 121,000 shares of National common stock, together with prejudgment interest at the rate of 6%. In determining the amount of "short swing profits" for which Texas International is liable, Texas International is entitled to deduct the amount of expenses incurred in the purchase and sale of 121,000 shares. The Court concludes further that National may not recover as "short swing profits", the dividends received by Texas International on June 29. Finally, the Court concludes that as a genuine issue of material fact exists as to whether the option to purchase agreement presented an opportunity for speculative abuse, the Court must deny National's request for a pro rata portion of the three million dollars attributable to the 121,000 shares of National common stock. Accordingly, the Court grants defendant's motion for summary judgment in part and denies it in part.

Before the Court can determine the amount of "short swing profits" to which National is entitled, the Court must ascertain

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8 In awarding the defendant prejudgment interest, the Court is unpersuaded that the rate of prejudgment interest should be the average prevailing rate for short term commercial paper during the period subsequent to July 28, 1979. The usual rate of prejudgment interest of 6 per cent is fair and reasonable, and the Court sees no reason to award a higher rate.

the amount of incidental expenses incurred by Texas International in the purchase and sale of the 121,000 shares of National common stock. As that amount has not been documented sufficiently in the memorandum filed by the plaintiff, the plaintiff is hereby ordered to submit within twenty (20) days an affidavit containing a breakdown of those expenses. National is given an additional ten (10) days to respond to the affidavit submitted by plaintiff.

DONE at Houston, Texas, on this the 11 day of May, 1981.

/s/CARL O. BUE, JR.
Carl O. Bue, Jr.
United States District Judge

Appendix C

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

Civil Action No. H-79-1609

TEXAS INTERNATIONAL AIRLINES, INC.

—v.—

NATIONAL AIRLINES, INC.

ORDER

On May 11, 1981 the Court entered an Order granting, in part, defendant's motion for summary judgment as the Court had concluded that plaintiff, a corporate insider, had purchased and sold 121,000 shares of National Airlines (hereinafter National) common stock within a six month period in violation of § 16(b). The Court deferred its determination of the amount of "short swing profits" for which plaintiff was liable, however, until plaintiff submitted an affidavit containing a breakdown of the incidental expenses incurred by plaintiff in the purchase and sale of the 121,000 shares of National common stock. Pursuant to the Court's Order, the plaintiff has submitted such an affidavit setting forth those items of expenses which it claims.

In addition to the amount of brokerage commissions which were incurred in the purchase and sale of 121,000 shares of National common stock, plaintiff seeks to offset the amount of short swing profits for it is liable by the following incidental

expenses: (1) the amount of $40,723.00 which constitutes the interest plaintiff paid on the money borrowed to purchase the 121,000 shares (such loan hereinafter referred to as margin loan); (2) a commitment fee of $1,771.00 paid to Manufacturers Hanover Trust Company, the entity from which plaintiff obtained a portion of the margin loan; (3) the sum of $10,822.00 which constitutes the fees paid to the banks' attorneys in connection with the margin loan; (4) $238,698 in expenses incurred in the issuance to the public of thiry-five million dollars worth of Guaranteed Floating Rate Notes, one of the purposes of the proceeds from the notes included repayment of the margin loan; (5) voting trust administration fees of $374.00 which were incurred with respect to the National shares owned by plaintiff; (6) investment banking fees paid by plaintiff to Smith Barney, Harris Upham & Company totalling $43,214.00; (7) the sum of $3,666.00, such sum constituting the cost of public relations, management and transportation consultants, consultation and testimony relating to the Civil Aeronautic Board proceeding to acquire National, and accounting; (8) legal fees of $91,223.00; (9) commitment fees totalling $18,343.00; (10) miscellaneous disbursements of $1,926.00 which include the cost of printing and supplies, the unidentified expenses of certain individuals employed by plaintiff, computer services cost, transcripts costs, news clipping costs, newswire services cost, courier services, the cost of a "Texas Delegation breakfast"; and, (11) the sum of $23,000.00 which constitutes estimated management and clerical time spent in support of the margin loan, floating rate note offering and the effort to acquire National from March 14 through July 30, 1979.

Not surprisingly, defendant is opposed to the amount of incidental expenses claimed by plaintiff. Although defendant concedes that plaintiff is entitled to offset its section 16(b) liability by the amount of brokerage commissions and transfer taxes incurred in the purchase and sale of 121,000 shares of National common stock, $9,680.00 and $437.50 respectively, defendant asserts that permitting plaintiff to include the additional amounts sought as incidental expenses is unsupported by

the case law and would circumvent the purpose of section 16(b). This court is inclined to agree.

After careful consideration of the briefs filed by the parties in light of the relevant law, the Court concludes that plaintiff is entitled to deduct from the "short swing profits" for which it is liable the sum of $10,117.50, such amount consisting of the brokerage commissions and transfer taxes incurred by plaintiff in the purchase and sale of 121,000 shares of National common stock. To permit plaintiff to deduct any further expenses would circumvent the purpose of section 16(b) " 'of preventing the unfair use of information which may have been obtained by [a statutory insider] . . . by reason of this relationship to the issuer.' " *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 591 (1973), citing from the introductory clause of section 16(b), 15 U.S.C. 78 p (b) (1934). It has been stated that this purpose is best achieved by squeezing "every possible profit out of such transactions." *Blau v. Lehman*, 286 F.2d 786, 791 (2d Cir. 1960), *aff'd*, 368 U.S. 403 (1962). Accordingly, the Court concludes that plaintiff is entitled to deduct only the sum of $10,117.50 from the short swing profits for which it is liable. In accord *see Lane Bryant, Inc. v. Hatleigh Corp.*, No. 81 Civ. 941 (S.D.N.Y. Jul. 10, 1981), where the district court declined to permit a deduction of incidental expenses similar to those claimed by plaintiff in the case *sub judice*:

> Defendant seeks to reduce the amount of profits sought to be recouped from the $649,687.50 alleged by the plaintiff, to $486,567.53 on the grounds that there should be deducted from the profits administrative overhead expenses of $9,200 and interest on the loans secured with which to make the purchases of the stock amounting to $135,919.97.
>
> The defendant also suggests further deductions for office overhead in the sum of $5,500 for the six-month period involved and its lawyers' fees and costs of litigation referred to above, totalling $383,000.
>
> None of these attempted deductions is appropriate in calculating the short-swing profits. The profits on the

purchases and sales are not to be equated with the costs to the defendant of doing business, nor conducting litigation seeking the control of the enterprise. It would be inappropriate to permit the bank's administrative charges for handling the defendant's account or its interest charges on loans which the defendant secured to enable it to finance the purchases to reduce the profit on the trades.

The profits contemplated by the statute are profits from the purchase and sale of the securities and not any costs such as bank charges, office overhead or collateral litigation which a party seeking control incurs. To permit the deductions claimed would be to encourage the type of transactions from which the statute squeezes all profit to be made on the basis of third party financing of the transactions which by itself would merely multiply the problems sought to be reached by Section 16(b).

Id. at 17-19.

Although the Court has determined now the amount of incidental expenses which plaintiff may deduct from the "short swing" profits for which it is liable, a review of the briefs on file has revealed an apparent conflict between the parties with regards to the amount of money plaintiff paid for the 121,000 shares of National Common Stock, and the amount plaintiff received when those same shares were subsequently sold. Accordingly, in order to assist the Court in determining the "short swing profits" for which plaintiff is liable, the Court directs the plaintiff to submit within ten (10) days an affidavit setting forth the amount of money plaintiff paid for the 121,000 shares and the amount plaintiff received when such shares were subsequently sold. National is given an additional five (5) days to respond to the affidavit submitted by plaintiff.

DONE at Houston, Texas, on this the 31 day of March, 1982.

/s/ CARL O. BUE, JR.

Carl O. Bue, Jr.
United States District Judge

Appendix D

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

Civil Action No. H-79-1609

TEXAS INTERNATIONAL AIRLINES, INC.,

Plaintiff,

—v.—

NATIONAL AIRLINES, INC.,

Defendant.

FINAL JUDGMENT

This cause came on to be heard on the motion for summary judgment filed herein by defendant and counter-plaintiff National Airlines, Inc. (herinafter called "National"). In its May 11, 1981 Memorandum and Order, which is incorporated by reference herein, the Court granted in part and denied in part National's motion. In its March 31, 1982, and April 23, 1982 Orders, which are also incorporated by reference herein, the Court ruled on the only remaining issue raised by National's motion, dismissed at National's request its remaining claim on which summary judgment had been denied, and directed the entry of a final judgment in accordance with these three Orders.

Therefore, in accordance with the Court's May 11, 1981, March 31, 1982, and April 23, 1982 Orders herein, to which reference is here made, it is now ORDERED, ADJUDGED, and DECREED that:

1. Plaintiff Texas International Airlines, Inc. (hereinafter called "TIA"), take nothing by its suit and that its Complaint for Declaratory Judgment be, and the same is hereby, dismissed with prejudice;

2. That, on its Counterclaim against TIA, National do have and recover of and from TIA the sum of $1,149,195.00, together with interest thereon at the rate of 6 percent per annum from July 28, 1979, to July 10, 1981; at the rate of 12 percent per annum from July 10, 1981, to the date of this Final Judgment; and at the rate of 9 percent per annum from the date of this Final Judgment until paid;

3. That National do have and recover of and from TIA its costs of court; and

4. That all other relief prayed for by either TIA or National that is not expressly granted herein, be, and the same is hereby, denied.

DONE at Houston, Texas, this 10th day of May, 1982.

/s/ CARL O. BUE, JR.

Carl O. Bue, Jr.
United States District Judge